What Is Universal Life Insurance?

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By definition, something that is universal should be for everyone. In theory, that is the goal of universal life insurance, which is part life insurance, and part savings and investing account.

Sometimes called cash value life insurance, universal life insurance is a permanent life insurance policy, which means it has a guaranteed death benefit that covers the insured person's lifetime, as long as the premiums are paid.

It also has a built-in savings account, or cash value, that you can borrow against tax-free. As you build cash value, you can use that money to pay the premiums. The goal is to build enough cash value to eventually pay all the premiums, eliminating out-of-pocket expenses for life insurance coverage.

Both the price of the premium and the death benefit amount are often flexible. The cash value grows and earns interest in a variety of ways, depending on the type of universal life policy.

The ability to use the cash value to pay premiums, and the flexibility of the premiums and death benefit distinguish universal life policies from whole life policies. With a whole life policy, the premium is set, and if you don't pay, the policy lapses.

"When universal life was created [in the 1970s], it was designed with reference to the things that whole life did not do well," said Steven Weisbart, senior vice president and chief economist of the Insurance Information Institute. "It is designed to be flexible, giving the person buying and owning the policy a number of options to make decisions about what they're buying that you couldn't get in a whole life policy because it isn't flexible."

When you take out a universal life insurance policy, the cost of your premium is based on the amount of coverage and your age and health.

The premium includes charges for policy administration and the cost of insurance, which pays for the death benefit. Together, they are the minimum amount necessary to keep the policy active. As you age, the cost of insurance (COI) often increases. Any amount paid above the premium goes to the policy's cash value, which earns interest. The fees involved are all transparent.

"With whole [and term] life insurance, [the COI] is kind of built into the price, so nobody knows how much money is really being taken out by the company for its expenses," Weisbart said. "For universal life, that is required to be disclosed separately to the policyholder."

The amount you pay toward a universal life policy on a routine basis is flexible, allowing you to decide how much to pay within a set range.

For example, you could pay more when you are younger to build the cash value while the cost of insurance is relatively low. Then you could use that increased cash value to cover the higher cost of insurance when you're older, so you basically get life insurance without paying premiums out of pocket.

Unlike term life and whole life policies, which require you to pay the premiums every time they're due, universal life policies give you the freedom to skip a payment as long as you have sufficient cash value.

"If you're investing and your cash value is going through the roof, you can say, 'Well, I just will skip my quarterly premium payment this time and let the insurance company take it out of my cash value,'" Weisbart said. "So you get all kinds of flexibility there. You can say, 'Well, I'll just pay half the premium this time and let the insurance company take the rest of it out of the cash value.'"

As the cash value builds, you can use it like a savings account and borrow against it. But if the cash value reaches $0, the policy can lapse. If you decide you no longer want the policy, you can surrender it and receive the policy's cash value.

3 Types of Universal Life Insurance

All universal life insurance policies include a cash value that can be withdrawn at any time. How that money grows depends on the type of policy you buy.

Indexed Universal

These policies are linked to market indexes, such as the S&P 500, Dow Jones and Nasdaq. If the market the policy is linked to does well, the cash value goes up, though the amount is usually capped.

The opposite is also true: If the market falls, the returns are lower, but there's a minimum, or floor, so you don't lose money. So if the floor rate is 1% and the market drops 9%, you will still earn 1%.

The gains typically reset annually, so the amount of cash is locked in and protected from a future downturn.

Guaranteed Universal

These policies have more protection from volatility because they are not tied to market performance, and the premiums do not fluctuate. Instead, both the premiums and the interest rates are set and fixed when you purchase a policy.

This type of policy usually has a lower cash value. There is often a no-lapse guarantee in this type of policy, so as long as you pay the premiums, there will be coverage.

Variable Universal

These are similar to indexed policies, but they allow you to invest the cash value into mutual funds. Variable policies often have higher fees than other types of universal life policies.

Weisbart said only 12% of all life insurance policies sold in the first quarter of 2019 were universal life policies. Out of all life insurance policies:

- Guaranteed policies were 6%.

- Indexed policies were 5%.
- Variable policies were 1%.

The remaining 88% were term life or whole life policies.

Why Should I Buy Universal Life Insurance?

In general, life insurance protects the financial security of a loved one when you die. If someone depends on your income and would be negatively impacted financially if you died unexpectedly, you should have some type of life insurance.

People buy universal life policies for a variety of reasons including:

- They want flexibility.
- It has cheaper premiums than whole life insurance.
- They want a guaranteed death benefit.

The premiums for universal life are higher than term life insurance policies that have a set time limit for coverage, but lower than for whole life policies with lifetime coverage. So universal life is a middle ground, a cheaper way to get permanent life insurance, but more expensive than term coverage.

When the insured dies, some universal life policies pay both the death benefit and the cash value to the beneficiaries.

Comparing Universal, Term and Whole Life Insurance

In general, universal life insurance policies are more flexible than term or whole life policies. But as a policyholder, you'll have a lot of choices to make during the time you own the policy, including:

- How much to pay in premiums each year.
- How much insurance to maintain.
- Whether to take money out of the policy.
- How the cash value is invested.

"The upside is you have all this flexibility," Weisbart said. "The downside is you've got all these choices to make and very few people honestly have the training or the inclination to learn enough to make informed choices."

	Universal Life	**Whole Life**	**Term Life**
Premium cost	Medium premiums	Highest premiums	Lowest premiums
Flexible premiums	Yes	No	No
Lifelong coverage	Yes	Yes	No
Cash value	Yes	Yes	No

	Universal Life	Whole Life	Term Life
Can use cash value to pay premiums	Yes	No	No cash value
Guaranteed death benefit	Yes	Yes	Yes (if the policyholder dies during the term of the policy)

Which Is Better, Term or Universal Life Insurance?

The key to determining which is better, term or universal life insurance, is to figure out why you are buying life insurance.

Critics of universal life say if the goal is investing and wealth generation, investing in mutual funds outside of your life insurance policy will cost you less in fees, and you'll have more control over your money.

If the main goal is to replace your income should you die so your survivors can pay for things like the mortgage, child care or school, a term life policy with a set time limit might be just what you need. As your children grow up and you pay off your mortgage, those expenses will go away, reducing the need for income replacement.

If you want to be able to build and borrow against a policy's cash value, you have a bit more money to spend upfront, and are not afraid to make choices about your finances, a universal life policy might be the way to go.

While the flexibility of a universal life policy is appealing, Weisbart warns that it can have a downside.

"Most [people who buy universal life policies] will go back to their the agent who sold them the policy and have a discussion from time to time about whether to change anything," he said. "I'm not convinced that people who buy these policies really want to spend this much time and energy making these choices and remaking them as they basically have to."

Tiffani Sherman is a freelance writer who likes saving money so she can use it to travel more.